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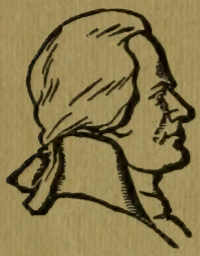
[Modern business Talks]

CAPITALIZING THE AUDITOR'S VIEWPOINT

The prosperity of a business concern may tempt to irregularities unless the books are rigorously scrutinized.



MODERN BUSINESS
TALK No. 42
(WITH VOLUME 21)

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Capitalizing the Auditor's Viewpoint

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This Talk, to be read in connection
with volume 21, forms part of
READING ASSIGNMENT 42

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READING ASSIGNMENT

The current Reading Assignment consists of three parts: (1) this Talk, (2) Part II of Volume 21, "Accounting Practice and Auditing", and (3) Problem No. 21.

Business men know the value of a fresh viewpoint on their affairs, and giving it is no small part of the service which the auditor renders business. A new outlook on business is the reader's gain from the present assignment. He learns to look upon affairs with a searching but calm and deliberate criticism. He cannot read the Text on Auditing without imbibing some of its spirit —a spirit that will temper his judgment and protect him against ill-considered action.

Capitalizing the Auditor's Viewpoint

An auditor is the Yankee of the business world. He is persistently asking questions and he continually "wants to know." To the indolent easy-going man of business the auditor is an unmitigated nuisance. He calls the auditor a meddlesome busybody who is "always taking the joy out of life." It is true indeed that by the nature of his occupation the auditor is a critic, but when you pay for criticism it is presumed that you want criticism, not whitewash or soft soap. That doesn't make the critic a killjoy.

It must, however, be confessed that auditors are rarely popular with those whose work is submitted to their scrutiny. There is often a feeling that the auditor is an outsider, who is only a licensed butter-in. There is often a suppressed scorn of the "expert." After all it is human nature to be suspicious of a man who thinks he knows more about your business than you do yourself, and this is quite independent of the fact that the other man may be wholly right in thinking so.

If progressive business men have any sneaking sympathy with the views expressed they sternly repress it. They welcome the auditor with open arms, give him free rein and answer his questions patiently.

They know that in so doing they are being placed in a position to see their business with other eyes. There is an old saying that "our best friends tell us of our faults", to which the cynic has added that "they then cease to be friends." Intelligent business men are usually big enough to let the auditor tell them of their faults, and thank him for his kindness. Now of course it must not be understood that it is technically any part of an auditor's business either to criticise or advise. In theory he is a cold impersonal being who certifies to a state of facts. In practice he is very often a red-blooded individual, who cannot help stating his facts in such a way and commenting upon them in such a fashion that praise or blame sticks out unmistakably from his formal report.

The current reading assignment in the MODERN BUSINESS Text analyzes step by step the service which the auditor renders to the business manager. How useful an auditor can be in straightening out tangled situations, in letting in a flood of light on dark spots, and thus preparing the way for better business policies, is seen in the experience of a man who was invited to purchase a considerable interest in an apparently prosperous enterprise.

LOOKING FOR A BUSINESS OPPORTUNITY

Some fifty years ago Dockery and Stokes had been inseparable at college. Later Dockery went west where he established a machine shop, while Stokes remained in the east. Both prospered and when the machine shop blossomed into the Dockery Manufac-

turing Company, Stokes was glad to take some of the stock and accept a place on the board of directors.

Their sons came together at college and continued the fathers' friendship. Both were trained as engineers, but while Phil Dockery went into his father's works, Harry Stokes went with an engineering firm which sent him out on construction and installation work in all parts of the world. When the elder Stokes died, Harry was the sole heir. He returned to the United States and was obliged to spend some time in winding up his father's affairs. He was elected a director in the Dockery Company and Phil wrote to his old friend, suggesting it was about time to settle down.

"Why not come with us?" he had written. "The machine works are growing. It is a chance for you. Father is easing up and if you feel like acquiring a larger interest in the concern I think it can be arranged. So far as I am concerned I should be only too glad to turn over the general management to you in order to get time to look after my other interests."

With this assurance of President Dockery's favorable disposition, Stokes went to look over the ground and to talk business. The concern was large and prosperous; its reputation the best. His preliminary chat with Phil Dockery convinced Stokes that he could have all the stock he wanted at the right price and that he could take hold any time he wished as Vice-President and General Manager with a free hand and at a satisfactory salary.

The following morning the new director went down to the works to look them over and meet the department heads. He found the works well organized with a wide-awake superintendent in charge. The men at the head of departments were generally friendly in their greeting, but when he met the treasurer, Mr. Oakes, Stokes had the feeling that he was about as welcome as a wet dog in a ballroom.

He took Dockery aside and said, "Of course the members of the board have some inkling as to why I am here. Do you think they relish the idea of an outsider coming in—Oakes for instance?"

"Why no", Dockery admitted; "Oakes rather hung back, but I wouldn't take that seriously, he is always a bit offish, but he is a fine fellow just the same, and a great chum of my father's."

Auditing from the Inside

Later at a conference in the president's office, Stokes was given a copy of the financial statement. After a preliminary glance he said, "It looks all right. When was the last audit?"

"In December", said the president.

"Then this is it", said Stokes. "Who made it?"

"It is mine", said the treasurer, "I am a certified public accountant."

"What", said Stokes, "am I to understand that we don't have outside audits?"

The treasurer grew red in the face and looked at the president who remarked that the company had not considered it necessary to go beyond their own

expert officer. "As a matter of fact", he continued, "we haven't a very high opinion of auditors. Two concerns we know have had some very unfortunate experiences with them. In one case the office was disorganized for months and in the other there was a leak of information that is believed to have occurred thru one of the auditors."

"Even if that were so", said Stokes, "they got the wrong auditors. If they had hired incompetent or dishonest lawyers, superintendents, chemists or engineers they might have had the same kind of experience. It seems to me it is time we had a professional audit of our concern. Of course that would be no reflection on your ability, Mr. Oakes."

Oakes made no reply.

Threshing Out the Question

After dinner that evening in the president's house, Stokes took up the subject of the audit again with President Dockery and his son. "Oakes isn't here and I can talk more freely. Evidently you haven't settled this question among you and it is necessary for me to explain my position. Let's be perfectly plain. As a director, I have the right to know exactly how the business stands. As a possible investor I am entitled to have it passed on by an expert. Now there is no objection to this outside audit except Mr. Oakes' sensitiveness.

"I can't read books myself and I will look for an auditor to do that for me. I shall be satisfied with an examination by any well-known accountant.

"If your stock were on the market you would have a certified audit, and you realize that. Of course I make no reflection on Mr. Oakes or his bookkeeper, but they see only one side. Personally, I should as soon think of getting along without a professional lawyer, engineer or doctor. I have lived so much in out-of-the-way places that I am something of a doctor myself, but when I am sick I hire one. Even if he tells me what I already know it is a great satisfaction to hear it.

"You appreciate that most losses in business are avoidable, that they come from haste, carelessness, dependence on others. Executives do not always know what they are doing. They don't get all the facts, or don't study them long enough to get their full meaning. They pick the wrong kind of subordinates and trust them too far. Then they wonder afterward how they came to blunder.

Getting Basis for Guidance Out of Books

"Much of the information managers need for their guidance lies more or less buried in the books. The right sort of accounting will bring the truth, 'the whole truth and nothing but the truth', about every part of the business to the top. By comparing our figures for different periods we can find out exactly whether this function or that department is going ahead, standing still, or worse—whether a given method is justifying itself or not. We can know precisely where and how to move.

"If accounts will do this, why not have the very

best kind and why not know that we have? Why not have regularly an unbiased examination by the best available outside expert that we can have confidence in? You may be sure that he would present a report of the facts in such a form that we could interpret it intelligently and know positively just how we stand. The biggest concerns, even tho they may have their own auditors, often as officers of the company, submit their affairs to outside audit, and not only that but they have it continuously, partly for the moral effect, partly for safety's sake, but largely too because an ounce of prevention of errors in management is worth a pound of cure."

"Well", said Mr. Dockery, "there is no reason why you should not be satisfied on every head. We have nothing to conceal and I have no further objections to outside audit."

"Feeling" Things Are All Right

"I think if the truth were told", said Phil Dockery, thoughtfully, "we've depended to a certain extent on sentiment rather than on exact knowledge. Things here seemed to be going all right and we have felt they were right; consequently we haven't gone behind the returns. I don't mean that we have shut our eyes, but we have just naturally concentrated on what seemed to be the important things and let most of the others go. We haven't analyzed the business from every angle. I wonder now what we've been overlooking."

"Well I suppose the main constructive use to be

made of accounting records and statistics", said Stokes, "aside from analysis for ideas, is in estimating anticipated economies. Economies, you know, are sometimes deceptive. It all comes back to sound records. Again, these will, if properly arranged, show up the strong tendencies, which you can then check or encourage as you like. These things your treasurer probably is doing, but, as I said before, he is an insider. You need to have some hard-hearted business detective nosing around thru the accounts, ready to upset with cold fingers your pet little theories, when they are wrong, and destroy your cherished illusions. You know you can't depend on a friend to do that. How do you know how many pleasant little traditions Mr. Oakes is keeping alive merely to humor one or both of you? And yet you really want to know, don't you?"

"I can see that an auditor's report would make it a whole lot easier to do business with the banks", said Philip. "We never suffered, but we could have had out-of-town accommodation with a lot less talk if we had had audited statements."

In Case of Large Capitalization, or Merger

"Exactly", said Stokes, "and suppose some time in the future we want to double or treble our capital and sell stock, or float a large issue of bonds; an audit then would practically be indispensable. We might go into a merger. How easily it might make a difference of thousands of dollars to us whether our financial figures were backed by some big firm

of accountants. As a matter of fact, they probably would have to be, anyway."

"There's the income tax report, too", suggested Philip. "Even Oakes had a struggle with that and we might easily have lost enough to pay for the cost of an auditor."

"Fire loss is another contingency", said Stokes. "Adjustments are much more rapid and satisfactory if the accounts are beyond criticism. Surety companies generally expect that accounts of employes under bond will periodically be audited by a professional accountant. Remember, too, that when you employ a first-class auditor you are getting the services of a man who is not only an accountant, but a good deal of a lawyer and economist into the bargain. In a great many cases, he is better than a lawyer, because he knows business as well as business law. In short, if records are fundamental, the best assurance about them is none too good."

The elderly president smiled amiably and said, "We shall be happy to meet your wishes, Harry. I will take it up with Oakes."

The treasurer was told next day and made no further objection. Stokes left for home that evening after a word with his friend.

Reliable House Needed to Make Audit

"Well, there remains only the audit, Phil", he said, "and I'm sure it will merely back up your accounts. By the way", he added as a thought struck him, "our friend Oakes isn't any too keen on this

matter—I hope he'll get a good house to make this audit."

"Don't worry, old man", said Philip. "I'll give it my personal attention."

It turned out well that he did so. Oakes had fixed upon a somewhat obscure accountant of a near-by city and it took all of young Dockery's eloquence to persuade his easy-going father again to overrule the treasurer and insist on the audit being made by an accounting firm of national reputation. The treasurer had fumed at this new interference, but had ended by yielding. The audit was arranged for the following month.

"And, William", said the president, laying his hand on his old friend's shoulder, "let us old fellows pocket our pride and put our personal inclinations aside for the sake of the business. Let's give the younger men and this auditing crew full sweep and not leave anything for further criticism."

The treasurer bowed without answering.

When the auditor and his assistants arrived they found many of their desires anticipated. A separate room near the treasurer's was set aside for them, assuring a proper privacy. The head bookkeeper had also arranged to turn over the books for certain parts of each day. The fullest cooperation was pledged and given.

It was some days after the audit had started that young Dockery, the general manager, was surprised one evening to receive a call at his home from the visiting auditor.

"Won't this wait until tomorrow, Mr. Askew, when you can see me at the works?" asked Dockery "I am going out this evening."

Turns Up an Item That Needs Explanation

"You can judge of that after I have told you my errand", said the auditor. "I have found an item of $100,000 on the books that needs explanation. I have deemed it wise to bring the information to you here." He stopped and let the words sink in.

Dockery sat still, staring.

"Five years ago", the auditor went on, "your board authorized the treasurer to buy in $100,000 outstanding bonds."

"Yes", said Dockery, "and he did so. I remember all about it."

"Yes", said the auditor, "he did. The vote by inference gave him the necessary right to take the cash for that purpose out of the treasury, since no other method of obtaining the funds was indicated. He handled it thru his personal account in the corporation's private books which he alone kept. He drew the cash, charging it to his personal account, and with the money purchased the bonds. When the bonds had been received, he made an entry, charging the bond account and crediting his personal account for the $100,000.

"Well", said Dockery, "is there anything wrong with that?"

"No", answered Askew, "but I have come to tell you that there was a reserve account of $100,000

set aside for the express purpose of retiring the bonds, and that it has disappeared."

"Go on!" said Dockery, eagerly.

"I found an entry which sent me back to the old books. I found that ten years prior to the taking up of the bonds—fifteen years ago, in all—a reserve account was opened with a credit of $10,000. Each year for nine years more a similar credit was made. Five years ago the bonds were bought in. And, as I told you, they were bought out of 'cash'. Did you know there was a reserve account of $100,000?"

"If I did, I'd forgotten it", said Dockery. "But where did the reserve go?"

Entry in Private Journal Put Him on Track

"What put me on the track", said the auditor, "was an entry in the private journal of the corporation. I have a copy here. I'll read it:

Reserve to retire bonds.....$100,000
To William H. Oakes..... $100,000
To transfer to W. H. Oakes, Treasurer, the Reserve set aside to retire bonds per resolution of Directors May 5, 19—, which he has now done and which bonds are now handled and deposited in the company's safe deposit box.

"I had already come across withdrawals by Mr. Oakes that did not seem to be covered by salary or other reasons, and I went back looking for the source of the credit. When I found the $100,000 entry, that of course needed further explanation."

"Is there no other way out?" asked the general manager.

"I'm afraid not", returned the auditor. "I came across this yesterday and have been verifying it in every way ever since."

"Have you spoken to—Mr. Oakes?"

"No, Mr. Dockery", said the auditor.

"Are you willing to meet him tonight?"

"Quite."

The story is virtually told. When Dockery, his father and the auditor got to Oakes' house the treasurer was gone. In some way he had got wind of the auditor's discovery. They found that during the previous week he had turned what he could of his belongings into cash.

"But how could he have done it?" asked the elder Dockery afterward. "We have had the stockholders' auditing committee go over the books each year."

The Time for Pessimism

"They weren't looking for trouble", said the auditor smiling. "They expected everything to be all right. We professional accountants know there are always errors. If we found a company's accounts 100% perfect we should lose faith in ourselves. In your case it probably happened this way. Oakes and all the rest of you had temporarily forgotten the existence of the special reserve account. He had to have an additional authorization to pay out cash for the bonds. Then afterward he found he had this credit of $100,000 on his books with nothing to show why it was there. To what account should he transfer it? He hesitated. The tempta-

tion came and he found it too great. He transferred the item to his personal account and then afterward, when nothing was said about it, gradually liquidated his liability by paying it out in small sums to himself."

"But that doesn't explain how we came to overlook a $100,000 reserve", said the president.

"Well", said the auditor, "nearly all the mistakes auditors turn up in accounts do seem avoidable. The executives always wonder afterward how they came to overlook things."

These were Stokes' very words, Philip Dockery recalled.

The defalcation was not a serious blow to the company. It did not prevent Stokes from entering and he went in with even more prestige than he had before. Under his management, the property has since largely increased in value, which is held to be due in no small measure, as his friends tell him, to the fact that he had the auditor's viewpoint.

"How to be the right kind of a pessimist" might well be the title of this current reading assignment. The successful business man can boost all he wants to outside of his office and factory; when it comes to his own performance and that of his office and factory people, he has got to be a stern critic. Sloughing off the old played-out methods and policies—that is progress.

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